EU covered bond harmonisation on the home stretch but gaps remain

The European Commission's Covered Bond Directive and corresponding changes to the Capital Requirements Regulation should facilitate cross-border capital flows within the Eurozone. But they won't lead to uniform credit quality among covered bonds.

The Commission's covered bond harmonisation project[1] is on the home stretch. Following the end of the consultation period, the Directive goes in front of the European Parliament for a vote. Covered bond investors will have to embrace a wave of amendments to covered bond legislation in 2019/20 as the final directive will have to be transposed into national law within one year.

In Scope's view, the proposed amendments will strengthen investor confidence in the credit quality of covered bonds but are unlikely to have a strong impact on the credit quality of existing covered bonds. Still, the amendments will allow regulators to justify ongoing preferential treatment for covered bonds – for the benefit of issuers and investors.

The Directive will provide more clarity on cover-pool risks but remains broadly silent on maturity mis-matches or other market risks. Despite being a principles-based Directive, the Commission should provide more affirmative guidance on the definitions and their interpretation to avoid national ambiguities. In Scope's view, the improved transparency on covered bond-specific supervisory duties is a plus to the current status quo, but room for further improvements remain.

Scope notes that the Directive will not be able to align covered bonds' credit quality across member states as it predominantly addresses risks to the covered bond structure. The credit quality of a covered bond does not only reflect the credit strength of the covered bond programme but also the credit quality and dynamics of the issuing bank[2].

Further, the need to revert to the second line of recourse – the covered bond programme – has already reduced significantly due to the implementation of the European Bank Resolution and Recovery Directive (BRRD). A 'jump to default' and sole recourse to the cover pool for timely and full repayment of a covered bond is now the least likely scenario for an investor. The credit quality of the issuer will thus remain one of the driving factors for the credit quality its covered bonds.

Last, the Directive will not align credit risk for covered bonds issued in different member states. Macroeconomic developments will continue to differ and the respective impact on the credit quality of the bank or its cover pool will not be uniform.

The principle based harmonisation will not remove differences between countries and issuers; varying credit qualities will persist among European covered bonds.

[1] Initiative on an integrated covered bond framework https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-94_en
[2] Covered Bond Rating Methodology, last updated July 2017

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Directive provides more clarity on cover-pool risks …

Generally, Scope Ratings views the Commission's principles-based harmonisation proposal positively. The proposed Directive and the regulatory 'labelling' will clarify uncertainties for investors with regard to the treatment of covered bonds upon the insolvency of the issuer; provide more clarity on eligibility of cover assets and the maintenance of an 'evergreen' cover pool – while also adding a stronger and more comparable supervisory framework across Europe (see Figure 1).

Commission delivers a blueprint for less fragmented European covered bond frameworks

On the basis that markets were expecting less fragmentation among covered bond legislations as well as clarity on the insolvency remoteness of covered bonds to result from the Directive, the Commission delivered.

The Covered Bond Directive defines the status of covered bonds upon an issuer's insolvency and the segregation of cover pool assets and transition to a "stand-alone" structure more clearly than the UCITS Directive. And in combination with the revised CRR, it puts more emphasis on providing a definition of eligible cover assets as high-quality, homogenous and similar in structure, lifetime and risk.

Fine-tuning can further reduce credit risk

However, from a credit-risk perspective, the portfolio's granularity may also play a major role if it comes to tail risks commensurate with high ratings. Accordingly, portfolios with large individual exposures may suffer higher losses compared to highly granular pools. Consequently, the framework could benefit from additional concentration limits as already present in the legislation of some EU jurisdictions.

Limits could also reduce a programme's exposure to counterparty risks if market or credit risks are hedged using complex total-return-swaps or large macro hedges. Such derivatives may be hard to replace despite proper documentation and triggers in place.

Independent cover-pool monitor could avoid ambiguous eligibility interpretations

Scope views positively that all cover assets need to be eligible and identifiable. At the same time, determination of their eligibility often only rests with the issuing institution. A cover pool monitor, tasked with the day to day compliance of the relevant covered bond requirements, only remains an option according to the Directive. To avoid a dilution of a covered bond programme's credit quality, an independent cover pool monitor, not bound by directions of the issuer, can more proactively act as a gatekeeper – compared to the ex-post monitoring by supervisors. In times of stress, an institution might apply different interpretations to increase covered bond issuance potential.

Bank regulators can impose higher capital requirements where warranted and have become more transparent on additional capital charges. They acknowledge that the concept of static minimum capital requirements does not allow them to address issuer-specific pockets of risk.

Static over-collateralisation not ideal for dynamic risks in covered bonds

In this context, Scope notes that the static minimum nominal over-collateralisation (OC) of 5% (or 2% depending on the valuation method) does not follow this concept and does not provide a similar level of minimum protection across covered bond programmes. The ability to impose higher and transparent minimum OC requirements did not find its way into the European covered bond harmonisation proposals.

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Figure 1: Key elements of the Directive and amended CRR

- The Directive confirms dual recourse as the core-element of a European Covered Bond. The first recourse for a covered bond investor is against the issuer and the second against clearly identified cover assets.
- Covered bonds will not accelerate upon an issuer event of default (or its resolution); cover assets will be solely available for the benefit of the covered bonds. Cover assets shall consist of high-quality and homogenous assets with additional characteristics determined in the CRR.
- Derivative contracts are exclusively allowed for risk-hedging purposes and must not be terminated upon the insolvency or resolution of the issuer.
- Short-term liquidity mismatches shall be mitigated with a sufficient amount of highly-liquid assets that can buffer the net liquidity outflow for 180 calendar days. Alternatively, national legislation can allow for maturity extensions provided the extension is not triggered at the discretion of the issuer.
- Coverage of a covered bond programme shall be calculated on a nominal basis and must consider not just interest and principal on the covered bonds but also operational costs related to maintenance and administration costs. The CRR introduces a static minimum over-collateralisation of 5% on a nominal basis
- The Commission's proposal also specifies the option to appoint a trustee or special administrator. Furthermore, requirements and competence of the public supervision, transparency guidelines and publication duties are more clearly specified.

… but remains broadly silent on maturity mismatches …

Missed opportunity to address key risk to covered bonds

There is a missed opportunity in the Directiive as the second most expected benefit[3]: the reduction of asset-liability mismatch risk and its impact on credit quality has not been fully addressed.

Scope views positively the fact that the Directive introduces mandatory short-term liquidity buffers for all covered bond programmes. It will also standardise the use of structural elements such as the "trigger" for soft bullets or the use of pass-through structures. Scope acknowledges that these measures will give the specific insolvency receiver of the covered bond more time to address the inherent structural mismatches and the risk of a bullet repayment.

Bullet repayment can ultimately prompt a covered bond insolvency

The length of past crises and the lack of strong guidelines for tightly managing such mismatches before a covered bond becomes 'stand-alone', still makes the acceleration of a covered bond programme a possible scenario. Fire-sales of cover-pool assets into an already illiquid market required to secure timely repayment of a maturing covered bond can i) significantly reduce available collateral, ii) wipe out available over-collateralisation and ultimately iii) force the cover pool into insolvency.

For some covered bond programmes, refinancing risk will be passed to investors using maturity-extension structures such as conditional pass-throughs. Some countries might add further regulations in their national translation of the Directive, while other EU covered bonds will remain highly exposed. Consequently, harmonisation will not be achieved for this risk factor.

[3] European Comission: Covered Bonds in the European Union: Harmonisation of legal frameworks and market behaviours, April 2017, p.50; reduced regulatory fragmentation of covered bond legislations: 74%; reduction of asset and liability side duration mismatches: 68%

… as well as other market risks

Treatment of other market risk will differ across Europe

Other market risks, such as interest-rate and foreign currency (FX) risks are only minimally addressed by the Directive. The terms and conditions of mortgage loans – the main collateral type for covered bonds – reflect national preferences and differ significantly across member states. Cover pools often comprise floating or foreign-currency denominated loans and collateral whereas covered bonds are mostly issued in euro with a fixed coupon, reflecting investor preferences.

The Directive allows issuers to hedge such risks with derivatives but leaves it up to national discretion to introduce limits and adequate stresses for a covered bond programme's exposure to them.

As such, the exposure of covered bond programmes to these risks and their impact on their credit quality will also vary.

Further guidance on terms to facilitate and harmonise interpretation

More affirmative guidance on terms and transition would be helpful

Scope believes that despite the aim of a principles-based Directive, the Commission should provide more affirmative guidance on the interpretation of key terms, the implications of failing to meet certain conditions and the transition between grandfathered and covered bonds issued under the new Directive.

Among the terms that could benefit from more clarity are “other high-quality assets” as well as the concept of “sufficient level of homogeneity”.

The lack of clarity on the transition to the new Directive could become disruptive in some countries (such as Spain). It might require higher management attention, will increase complexities arising from dual risk management and require enhanced transparency for investors and regulators to understand compliance with both regimes. Ultimately limited details about the transition might undermine some of the potential harmonisation benefits.

Improved transparency on covered bond-specific supervisory duties …

Supervisory duties become more explicit and uniform

The Directive provides more clarity on the general powers, obligations and competencies of supervisors and the requirement to have adequate covered bond-specific staff. Investors will benefit from the requirement for supervisors to become more transparent on the extent of their activities. Scope notes that the interpretation of what constitutes ‘specific regulatory oversight’ can significantly differ across Europe. Enhanced understanding on what is monitored by regulators (or not) will provide more comfort on the maintenance of a high credit quality cover pool.

….but room for improvement remains

The Directive stipulates additional transparency requirements to be provided by ‘competent authorities’. These include comprehensive disclosure of relevant rules and regulations, a list of supervised covered bond issuers as well as compliant covered bonds.

Transparency would benefit from publication in an additional language

The Capital Markets Union and the European Commission aim to simplify cross-country investments. Scope notes that the understanding of the supporting framework could be facilitated if such texts were also made available in at least one additional common European language. Publication of additional clarifications as well as legal opinions would further mitigate investor hesitancy to invest in countries operating with different legal concepts.

Similarly, Scope would appreciate more transparency on how to resolve conflicting priorities of regulatory bodies – in particular when their resolution is time-critical. In a resolution scenario, the intent of the supervisors tasked with the resolution of the bank might differ from that of the body supervising the covered bond. In the event the ECB is involved (for systemically-important banks) this cross-authority and cross-border conflict of interest may even be reinforced.

Digital transparency requirements to improve comparability

Finally, it would be of great support to market participants if data provision reporting were fully harmonised - similar to the provisions stipulated by the ECB for eligible securitisations. This involves a clear and definitive glossary to a consistent template, available to all market participants from a single source.

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